S&P Downgrade of the U.S. Long-term Credit Rating

Budget and Finance Committee

September 21, 2011

Background

- August 5, 2011, S&P downgraded the U.S. government's long-term debt rating to AA+, assigned a negative outlook (next two years) and confirmed the short term A-1+ rating
  - Citing political risk and rising debt burden
- Moody's affirmed its highest Aaa rating but assigned a negative outlook indicating potential risk of a downgrade (2-3 year timeframe)
- August 16, 2011, Fitch affirmed its AAA rating and stable outlook citing the "exceptional creditworthiness" of the U.S.
- While certainly historic, impacts from the downgrade are not expected to be significant for the City

Impacts to Municipal Issuers

- Credit Impacts:
  - S&P downgraded directly linked municipal bonds in tandem with the U.S. sovereign rating
  - Held off on evaluating indirectly linked credits until late November
    - *"…given the disparate nature of state and local economies, differing levels of reliance on federal funding, and varying management capabilities throughout the U.S. we anticipate the effects on the credit quality from the Budget Control Act of 2011 will likely be felt unevenly across the sector" – Standard and Poor's (8/19)*

- Demand Disturbances:
  - Negative municipal sector press
  - Additional tax-exempt mutual fund outflows
  - Liquidity Concerns

Impacts to the City

- <u>Credit Ratings:</u>
  - Since the City has no large funding dependencies on the federal government, it is unlikely that the City will realize a credit rating downgrade
- <u>Future Borrowings:</u>
  - As U.S. and global economic uncertainty continues, investors have flocked to known safe havens – U.S. Treasuries and highly rated municipal bonds – which has lowered yields
  - More will be learned when the City is in the market later in the fiscal year
    - Water, Series 2002 Refunding Bonds
    - CFD 2, Improvement Area 1 Special Tax Refunding Bonds

Impact to City Investments

- No Impact on Investment Strategy
  - Investment Policy does not specify minimum rating for government securities
  - Money market funds not downgraded
  - Bond indenture documents do not specify minimum rating requirements for government securities
- Primary Investment Objectives – Safety of Principal and Liquidity
  - U.S. government securities viewed as safest investments in the world
  - U.S. Treasuries deepest and most liquid market globally
- City's Pooled Investment Fund (as of 8/31/11)
  - 46.86% Treasuries, 30.91% Agencies, 3.10% TLGP (FDIC insured) Corporates
  - Highly liquid – 13% mature within 3 months, 21% within 6 months, 44% within 1 year

Financial Markets’ Reaction

- Treasury yields decreased since downgrade
  - Flight to quality trade on European debt concerns
  - Fears of a double dip recession
  - Expectation of further Fed monetary easing
- Spreads on agency and TLGP (FDIC-insured corporates) have increased slightly, mainly function of stresses in European and U.S. banking systems
- August 9, 2011 FOMC meeting, Fed indicated rates likely to remain extremely low through mid-2013
- Fiscal/debt concerns and potential further ratings downgrades could lead to higher yields in longer term